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To: The Honorable Donovan M. Dela Cruz
and Members of the Senate Committee on Ways and Means

Date: Tuesday, February 6, 2018
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 3073, Relating to Taxation

The Department of Taxation (Department) has concerns about S.B. 3073 and offers the following comments for the Committee's consideration.

S.B. 3073 conforms Hawaii's income tax law to new Internal Revenue Code section 199A. Section 199A allows taxpayers, other than corporations, (referred to as passthroughs for convenience) who receive income through a pass-through entity a deduction of 20% of their qualified business income. The deduction phases out for taxpayers who are in certain specified trades or businesses, including health, law, accounting, and athletics, among others. The phaseout threshold is $157,500 for single taxpayers and $315,000 for married taxpayers filing jointly. The bill becomes effective upon approval and applies to taxable years after December 31, 2017.

The Department notes that it is not recommending conforming to this provision in its statutorily required conformity bill. The deduction for pass-through income was provided to avoid upsetting the relative balance in rates of tax imposed on C-corporations and pass-through entities.

Forbes[1] reports the relative effective tax rates at the federal level before and after the Tax Cuts and Jobs Act (the Act).

	Before the Act	After the Act (without deduction)	After the Act (with deduction)
C-corporations	50.47%	39.8%	39.8%
Passthroughs	40.8%	37%	29.6%
Difference	9.67	2.8	10.2

1 https://www.forbes.com/sites/anthonynitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#865aa0144fda

This shows that the benefit in relative effective tax rates in terms of organizing as a pass-through would have been reduced from nearly 10 percentage points to less than 3 percentage points. Instead, given the passthrough deduction, the differential remains around 10 percentage points. This demonstrates why the passthrough deduction was enacted and why the specific amount of deduction was selected.

This justification for the 20% passthrough deduction is not applicable in Hawaii. Hawaii has its own corporate and individual tax rates that have not been amended and are not affected by the Act. Since the tax rates in Hawaii are unchanged conformity to the passthrough deduction is unneeded. Conformity to the passthrough deduction would reduce the effective tax rate on passthroughs while leaving the corporate tax rate unchanged in Hawaii.

Thank you for the opportunity to provide comments.